ELIZABETH WARREN, CHAIR
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOM C–320
WASHINGTON, DC 20401

Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of J. Mark McWatters

Congressional Oversight Panel Hearing on TARP and Other Assistance to AIG

May 26, 2010

Thank you Professor Warren.

I very much appreciate the attendance of the witnesses and I look forward to hearing their views.

The rescue of AIG has required the allocation of more taxpayer funded resources than any other bailout undertaken by the government since the inception of the current economic crisis. The Congressional Budget Office (CBO) has estimated that the TARP investment in AIG will cost the taxpayers $36 billion out of $70 billion committed or disbursed,[1] and the Office of Management and Budget (OMB) has projected that the investment will cost the taxpayers $49.9 billion.[2] Since our national resources are limited, the bailout of AIG will unfortunately require the government to reduce expenditures, increase tax revenue or both.[3]

The American taxpayers were told in the last quarter of 2008 that they had no choice but to bail out AIG because absent such action the world financial system might very well collapse due to the systemic risk presented by and the financial interconnectedness of AIG. That may indeed have been an accurate assessment, but it's critical to note that the world financial system does not consist of a single monolithic institution but, instead, is comprised of an array of too-big-to-fail financial institutions many of which, interestingly, were also counterparties on AIG credit default swaps (CDS) and securities lending transactions (SL). In other words, the concept of a "world financial system" is really just another term for the biggest of the big financial institutions and there remains little doubt to me that the principle purpose in bailing out AIG was to save these institutions as well as AIG's insurance business from bankruptcy or liquidation.

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[1] Link to CBO's "Report on TARP:" http://www.cbo.gov/ftpdocs/112xx/doc11227/03-17-TARP.pdf.
[2] Link to President's Budget: http://www.whitehouse.gov/omb/budget/fy2011/assets/econ_analyses.pdf.
[3] As I have done in prior hearings, I think that it's instructive to add some perspective to the magnitude of the loss the taxpayers may suffer as a result of the AIG bailout. By comparison, for fiscal year 2011 the National Institute of Health (NIH) has requested $765 million for breast cancer research, and the latest Nimitz-class aircraft carrier commissioned by the Navy cost approximately $4.5 billion. [See NIH "Estimates of Funding for Various Research, Condition and Disease Categories (RCDC)" at http://report.nih.gov/rcdc/categories/ and See "Information about the Ship," at http://up-www01.ffc.navy.mil/cvn77/static/aboutus/aboutship.html.] It is entirely appropriate for the taxpayers who funded the TARP program to ask if the bailout of AIG with a CBO estimated cost of $36 billion merited 47 years of breast cancer research or eight (8) Nimitz-class aircraft carriers. The "guns v. butter v. AIG" comparison demonstrates that our national resources are indeed limited and that the bailout of AIG will require the government to reduce expenditures, increase tax revenue or both.

It is ironic that although the bailout of AIG may have rescued many of its counterparties, none of these institutions were willing to share the pain of the bailout with the taxpayers and accept a discount on their termination payments. Instead, they left the American taxpayers with the full burden of the bailout. It is likewise intriguing that these too-big-to-fail financial institutions were paid at par—that is, 100 cents on the dollar—at the same time the average American's 401(k) and IRA accounts were in free-fall, unemployment rates were sky-rocketing and home values were plummeting.

It is also critical to recall that at this time many of the AIG counterparties were most likely experiencing their own severe liquidity and insolvency challenges and were under attack from short-sellers and purchasers of CDSs on their debt instruments. By receiving payment at par, some of the counterparties were able to convert illiquid and perhaps mismarked CDOs and other securities into cash during the worst liquidity crisis in generations.[4] In addition, by avoiding the risk inherent in an AIG bankruptcy and the issues regarding debtor-in-possession financing, some of the counterparties were also able to accelerate the conversion of their AIG contracts into cash, and in late 2008, cash was king.[5] Although some counterparties may argue that they held contractual rights to receive payment at par and were the beneficiaries of favorable provisions of the bankruptcy code, such rights and benefits would have been of diminished assistance since in late 2008 AIG was out of cash. It also appears problematic if AIG would have been able to obtain sufficient post-petition financing following the implosion of the financial system that—according to the wisdom of the day—would have followed the bankruptcy of AIG. Thus, without the taxpayer funded bailout, AIG would have held insufficient cash to honor in full its contractual obligations notwithstanding the special rights and benefits afforded the counterparties.[6] In light of this reality, it does not appear inappropriate for the taxpayers to expect a discount to par upon the termination of AIG's contracts with those counterparties who held the referenced securities but were not otherwise fully hedged against AIG-related risk with posted cash collateral.[7]

[4] If you're inclined to challenge this analysis, ask yourself one question: In the last quarter of 2008 what would you have rather owned—(i) a CDS with a bankrupt AIG that is searching the world for post-petition financing or (ii) U.S. dollars equal to the full face amount of the referenced securities underlying your CDS?

[5] While the facts and circumstances no doubt differed with respect to the contractual and economic relationships of the various counterparties with AIG, the bailout of AIG—at a minimum—reduced systemic risk throughout the world-wide financial system to the benefit of the counterparties and most certainly allowed some of the counterparties to receive a greater distribution than they would have received following the bankruptcy of AIG.

[6] It is worth noting that the amount of any discount to par is not the key issue. The American taxpayers have repeatedly proven themselves profoundly generous to the commercial and investment banking communities over the past two years. The acceptance of the numerous bailouts by the taxpayers, however, is founded upon the implicit understanding that Wall Street share the financial burden with the taxpayers. The bailout of the AIG counterparties at par without a gesture of support to the taxpayers breached that agreement.

[7] If an AIG counterparty was fully hedged with cash collateral posted by the protection seller to the AIG counterparty as the protection buyer under a CDS over AIG, the AIG counterparty would most likely recover the full benefit of its bargain even if AIG failed and was liquidated. Under these circumstances it appears unlikely that the AIG counterparty would offer a discount to AIG upon the bailout of AIG by the taxpayers because the AIG counterparty would be indifferent regarding the bailout of AIG by the taxpayers. Conversely, if the AIG

I appreciate that the senior management and counsel of some of the AIG counterparties may cite standards of fiduciary duty as a defense to their unwillingness to accept a discount to par. It is quite possible, however, that these officers owed a higher fiduciary duty which was to save their respective institutions from the very real threat of bankruptcy or liquidation that existed in the final quarter of 2008. After all, who can forget the photograph of the two-dollar bill taped to door of Bear Stearns's New York offices?[8] That image—like Charles Dickens's ghost of Christmas future—told the story of what *would* come to pass for other financial institutions, such as AIG and its counterparties, absent the intercession of the American taxpayers. In the dark days of late 2008 when AIG faltered the American taxpayers—not the New York Fed or Treasury—stood as the last safe-haven for many of these financial institutions and much of today's Main Street v. Wall Street debate would have never arisen if Wall Street had properly acknowledged the American taxpayers as its sole benefactor. As such, after the bailouts, it has become exceedingly difficult for many Americans to accept that what's good for Wall Street is necessarily good for Main Street.

Thank you for joining us today and I look forward to our discussion.

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counterparty was not fully hedged regarding the default by AIG under the CDS with the AIG counterparty, the AIG counterparty should be willing to offer AIG a discount to tear-up the CDS because—without the bailout of AIG by the taxpayers—the AIG counterparty would most likely suffer a loss upon the bankruptcy of AIG due to the collapse of the financial system (which includes the CDO and the DIP financing markets) that would follow such event.

In addition, since the counterparties under the CDSs that the AIG counterparties used to hedge their AIG-related risk were in effect bailed out upon the bailout of AIG, it would also not appear unreasonable for the taxpayers to expect a discount to par from such counterparties.

[8] See "Bear Stearns and the $2 Bill," Reuters, March 17, 2008, at http://blogs.reuters.com/reuters-dealzone/2008/03/17/bear-stearns-and-the-2-bill/.